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TELECOMMUNICATIONS ACCOUNTING ISSUES

**Before the Subcommittee on Oversight and Investigations
Committee on Financial Services
March 21, 2002**

Chairwoman Kelly, Ranking Member Gutierrez and Members of the Subcommittee:

I am pleased to appear before you on behalf of the Securities and Exchange Commission ("SEC" or "Commission") to testify concerning several accounting issues affecting the telecommunications industry. As the Subcommittee has requested, my testimony will address: 1) the accounting by providers of telecommunications capacity for the sale of an indefeasible right of use ("IRU") of such capacity, 2) the accounting for nonmonetary transactions, including "swaps," and 3) the reporting of pro-forma financial information.

Global Crossing Ltd. has disclosed that the SEC is investigating certain issues associated with Global Crossing's accounting and disclosure practices. Any further information relating to such an investigation would be nonpublic and, accordingly, my statement will be confined to the public record.¹

¹ The information contained in this statement concerning Global Crossing's accounting practices is based upon publicly available information.

Transparent Financial Reporting Protects the Financial Markets

A primary goal of the federal securities laws is to promote honest and efficient markets and informed investment decisions through full and fair disclosure. Transparency in financial reporting, that is, the extent to which financial information about a company is available and understandable to investors and other market participants, plays a fundamental role in making our markets the most efficient, liquid, and resilient in the world.

Transparency enables investors, creditors, and market participants to evaluate the financial condition of an entity. In addition to helping investors make better decisions, transparency increases confidence in the fairness of the markets. Further, transparency is important to corporate governance because it enables boards of directors to evaluate management's effectiveness and to take early corrective actions, when necessary, to address deterioration in the financial condition of companies. Therefore, it is critical that all public companies provide an understandable, comprehensive and reliable portrayal of their financial condition and performance. If the information in financial reports is transparent, then investors and other users of the information are less likely to be surprised by unknown transactions or events.

Investors and creditors expect clear, reliable, consistent, comparable, and transparent reporting of events. Accounting standards provide a framework that is intended to present financial information in a way that facilitates informed judgments. For financial statements to provide the information that investors and other decision-makers require, meaningful and consistent accounting standards and comparable practices are necessary.

Recent press articles have raised questions about the transparency of the accounting and disclosure practices followed by Global Crossing. In light of these articles, I would like to review the accounting by providers of telecommunications capacity for an IRU of such capacity, the accounting for nonmonetary transactions, including “swaps,” and the reporting of pro-forma financial information.

Telecommunications Capacity Purchase and Sale Agreements

The expansion of fiber optic communications increased the frequency of transactions involving the “sale” of network capacity. The granting of an indefeasible right to use such network capacity is often referred to as an “IRU.” Pursuant to an IRU, an entity purchasing network capacity has the exclusive right to use a specified amount of capacity for a period of time.

Accounting by the purchaser of network capacity pursuant to an IRU has not raised significant accounting issues. An entity purchasing capacity would typically record the amount paid for the capacity as an asset,² and amortize that asset by charges against income over the period of benefit, which would normally be the term of the capacity agreement.

For the provider of the capacity, the fundamental accounting issue related to an IRU is when to recognize revenue. That determination can be quite complex but can be boiled down to two basic questions: Is the IRU a lease or is it a service contract? And, if it is a lease, what kind of lease is it - a sales-type lease, for which revenue is recognized upfront, or an operating lease, for which revenue is recognized over time? Please allow me to elaborate on the details:

² Depending on the nature of the capacity purchase agreement, the purchaser would possibly record either a fixed asset, such as property, plant, and equipment, or a prepaid expense.

Step 1—Service contract or lease?

As I previously stated, the first step in determining when to recognize revenue is to evaluate whether the contract between the provider and purchaser of the capacity is an arrangement for the provision of a service or a lease. Although service contracts may have attributes similar to those embodied in leases, the accounting results may be dramatically different for service transactions than for leases.

Accounting for service contracts: Under generally accepted accounting principles (“GAAP”),³ revenues associated with long-term service contracts are generally recognized over time as performance occurs. The accounting guidance as to when to recognize revenue for service contracts is limited, but can be primarily attributed to the conceptual framework of the FASB and a paper published by the FASB on accounting for service contracts. The SEC staff communicated its views on various issues related to revenue recognition for service contracts in Staff Accounting Bulletin No. 101.⁴

Accounting for leases: FASB Statement of Financial Accounting Standards (“SFAS”) No. 13, *Accounting for Leases*, and the related interpretations of this standard, provide the relevant GAAP for lease accounting, including the definition of a lease. This accounting literature defines a lease as an agreement conveying the right to use property, plant or equipment for a period of time, and specifically excludes agreements that are contracts for **services** that do not transfer the right to use property, plant or equipment.

To the extent that a network capacity contract conveys to the purchaser the right to use specific identifiable assets⁵ for a period of time, providers of this capacity have concluded

³ While the Commission has the statutory authority to set accounting principles, for over 60 years it has looked to the private sector for leadership in establishing and improving accounting standards. The quality of our accounting standards can be attributed in large part to the private sector standards-setting process, as overseen by the SEC. The primary private sector standards-setter is the Financial Accounting Standards Board (“FASB”).

⁴ See Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements*, December 3, 1999.

⁵ For example, a specific fiber or wavelength of light within a fiber-optic cable network, along with the conduit through which that cable passes, the land on which the conduit rests, and a specific component of the telecommunications equipment at each end of the cable necessary to transmit data over the network, would represent specific identifiable assets.

that such a contract meets the definition of a lease. If the network capacity contract does not convey to the purchaser the right to use specific identifiable assets, the contract would be viewed as an arrangement for the provision of services, and revenue would be recognized over the period of the contract as the services (the access to the network capacity) are provided.

Step 2—It is a lease, but what kind of lease?

For capacity contracts that meet the definition of a lease, the next significant accounting consideration is the determination of the appropriate lease classification. In a network capacity contract or arrangement that meets the definition of a lease, the capacity provider is the lessor, and the capacity purchaser is the lessee. From the lessor's perspective, there are two general types of leases – sales-type leases and operating leases.

Sales-type leases: In a sales-type lease, which gives rise to manufacturer's profit, the lessor records the fair value of the leased assets as revenue upon inception of the lease. The cost (or carrying amount) of the leased assets is charged against income in the same period that the "sale" is recognized. Sales-type lease accounting reflects in the financial statements of the lessor a sale or financing when substantially all of the benefits and risks incident to the ownership of the leased property have been transferred to the lessee.

Operating leases: Alternatively, in an operating lease, the lessor continues to record the leased assets on its balance sheet, subject to the lessor's normal depreciation policies. The minimum lease payments are recorded as rental revenue by the lessor over the lease term, typically on a straight-line basis. Operating lease accounting is similar to service contract accounting.

For a network capacity transaction to be appropriately classified and accounted for as a sales-type lease, certain specific criteria must be met. Otherwise, the transaction must be classified and accounted for as an operating lease. Further complicating the issue, these criteria differ depending on whether the leased asset is considered equipment or real

estate. Under SFAS No. 13, and the related interpretations of this standard, a lease of real estate must transfer title in the leased assets to the lessee in order to be classified and accounted for as a sales-type lease by the lessor. Equipment leases need not transfer title in the leased assets to the lessor in order to be classified and accounted for as sales-type leases.

Real estate or equipment: The FASB issued Interpretation No. (“FIN”) 43 in June 1999 which was effective for transactions entered into after June 30, 1999.⁶ FIN 43 provides interpretive guidance on the definition of real estate for accounting evaluations. This guidance, along with additional interpretive guidance provided by the FASB’s Emerging Issues Task Force (“EITF”),⁷ has the general effect of rendering the assets subject to telecommunications capacity agreements as real estate for accounting purposes. When the interpretation in FIN 43 and the related EITF guidance became effective, many telecommunications capacity sellers concluded that they were unable to meet the title transfer requirement for the assets subject to the IRU and, therefore, were required to account for subsequent capacity sale transactions as operating leases. Prior to FIN 43, the assets subject to telecommunications capacity agreements were generally viewed as equipment, and frequently, providers of capacity accounted for these agreements as sales-type leases.

Industry Practice

In addition to these changes in the accounting rules, as the industry evolved, many capacity providers changed their service offerings to permit more flexibility than was previously available in fixed, point-to-point capacity sales. Because these more recent service offerings typically do not grant the purchaser of such services the right to use specific identifiable assets for a period of time, these arrangements fail to meet the fundamental conditions for being treated as leases, and instead are considered executory

⁶ See FIN 43, *Real Estate Sales, an Interpretation of FASB Statement No. 66*.

⁷ See EITF Issue No. 00-11, *Lessors' Evaluation of Whether Leases of Certain Integral Equipment Meet the Ownership Transfer Requirements of FASB Statement No. 13*, and EITF Issue No. 00-13, *Determining Whether Equipment is "Integral Equipment" Subject to FASB Statements No. 66 and No. 98*.

contracts (that is, contracts for the provision of services, which are specifically excluded from the lease accounting literature). Therefore, the sales-type lease accounting model may not be appropriate for more recent capacity contracts.

In administering the federal securities laws, the Commission staff has reviewed public filings of telecommunications network capacity providers and suggested that certain disclosures be made so that the accounting policies of telecommunications capacity providers are transparent to investors. In addition, the Commission staff has worked closely with the private sector accounting standards-setting organizations to identify issues related to the accounting for telecommunications capacity purchase agreements, and to resolve those issues in a manner that is in the best interests of investors. Two accounting issues have been addressed and resolved by the EITF that primarily relate to IRU accounting.⁸ Other issues on the EITF's current agenda could have an impact on the industry's accounting practices.⁹

Accounting for Nonmonetary Transactions

Several recent articles in the financial press have focused on the business practices of telecommunications companies "swapping" network capacity.¹⁰ Many of these articles suggest that the companies entering into these transactions may have inappropriately inflated their operating results by recognizing revenue for the network capacity sold, and recording long-term fixed assets for the capacity purchased. While I cannot comment on specific transactions, my testimony seeks to provide an overview of the accounting literature that addresses the accounting for exchanges of nonmonetary assets.

In general, GAAP requires that the accounting for the exchange of nonmonetary assets be based on the fair value of the asset received or given up, whichever is more reliably

⁸ See footnote 7.

⁹ See EITF Issue No. 01-08, *Determining Whether an Arrangement is a Lease*, EITF Issue No. 01-04, *Accounting for Sales of Fractional Interests in Equipment*, and EITF Issue No. 00-21, *Accounting for Revenue Arrangements with Multiple Deliverables*.

¹⁰ See, for example, "Optical Illusion? Accounting Questions Swirl Around Pioneer In the Telecom World," *The Wall Street Journal*, February 13, 2002, and, "Losing a Grip on the Fiber Optic Swap," *The New York Times*, February 18, 2002.

determinable.¹¹ One of the exceptions to this general principle is an asset exchange that does not represent the culmination of the earnings process. For example, an exchange of an asset held for sale in the ordinary course of business (such as inventory) for an asset to be sold in the same line of business. Furthermore, the exchange of a productive asset not held for sale for a similar productive asset also is not viewed as the culmination of the earnings process. These types of nonmonetary exchange transactions are required to be accounted for based upon the recorded amount, or book value, of the asset relinquished.

The simultaneous exchange of nonmonetary assets along with equal amounts of cash consideration between the parties to an exchange would raise significant “substance” over “form” questions. When cash consideration is exchanged between the parties to a transaction concurrently with an asset exchange, questions may arise as to the substance or business purpose of the transaction structure, and whether that structure has an economic purpose or is designed solely to remove the transaction from the scope of the accounting literature governing nonmonetary asset exchanges.

In these situations, a careful analysis of the specific facts and circumstances surrounding the transaction would have to be made. To the extent that the “check swapping” between the parties lacks economic substance, such a practice should not alter the accounting for such exchange transactions. In other words, the accounting rules for nonmonetary asset exchanges should be followed. These rules require that certain conditions be met in order for the transaction to be accounted for at fair value.

In order to conclude that a network capacity swap transaction should appropriately be accounted for as revenue and a capital expenditure at fair value, a company entering into such a transaction would have to reach the conclusion that: 1) the network capacity received in the exchange will not be sold in the same line of business as the network capacity given up in the exchange, 2) the network capacity received in the exchange is a productive asset that is dissimilar to the network capacity given up, and 3) the fair values

¹¹ Accounting Principles Board (the predecessor to FASB) Opinion No. 29, *Accounting for Nonmonetary Transactions*, provides relevant guidance on the accounting for these types of transactions.

of the assets exchanged are determinable within reasonable limits. Capacity swap transactions likely include complex terms that would require a diligent analysis and professional judgment to determine the proper accounting treatment.

Companies that engage in material nonmonetary transactions during a reporting period are required, under GAAP, to disclose, in the footnotes to the financial statements, the nature of the transactions, the basis of accounting for the assets transferred (that is, fair value or book value), and gains or losses recognized. GAAP also requires that information about all investing and financing activities of an enterprise that affect recognized assets or liabilities but that do not result in cash receipts or payments, such as nonmonetary asset exchanges, be disclosed in the footnotes to the financial statements.

Furthermore, the Commission's rules require registrants to include in their public filings a section entitled Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A").¹² In MD&A, registrants are required to discuss the known trends, demands, events, commitments and uncertainties that are reasonably likely to materially affect a registrant's liquidity, capital resources, and results of operations. To the extent that nonmonetary exchange transactions have a significant impact on a registrant's liquidity, capital resources, or results of operations, disclosure of these transactions in MD&A would be required.

Pro-forma Financial Information

Recent press articles have also focused on Global Crossing's use of "pro forma" financial information in its earnings releases. "Pro forma," in this context, generally refers to the presentation of earnings and results of operations on the basis of methodologies other than GAAP.

"Pro forma" financial information can serve useful purposes. Public companies may quite appropriately wish to focus investors' attention on critical components of quarterly

¹² See Regulation S-K, 17 CFR, Item 303.

or annual financial results in order to provide a meaningful comparison to results for the same period of prior years or to emphasize the results of core operations. There is no federal securities law prohibition preventing public companies from publishing interpretations of their financial results or publishing summaries of GAAP financial statements.

Nonetheless, the Commission is concerned that "pro forma" financial information, under certain circumstances, can mislead investors if it obscures GAAP results. Because this "pro forma" financial information by its very nature departs from traditional accounting conventions, its use can make it hard for investors to compare an issuer's financial information with other reporting periods and with other companies.

The Commission has cautioned companies and alerted investors to the potential uncertainties of "pro forma" financial information. Most recently, on December 4, 2001, the Commission issued cautionary advice that companies and their advisors should consider when releasing "pro forma" financial information.¹³ Among other things, this release reminded companies and their advisers that:

First, the antifraud provisions of the federal securities laws apply to a company issuing "pro forma" financial information. Because "pro forma" information is information derived by selective editing of financial information compiled in accordance with GAAP, companies should be particularly mindful of their obligation not to mislead investors when using this information. Recently, the Commission concluded its first pro forma financial reporting case ever, regarding the issuance of a misleading earnings release by the Trump Hotel and Casino Resorts, Inc.¹⁴ This action demonstrated the Commission's commitment to address the dangers of "pro forma" financials.

¹³ See Financial Reporting Release No. 59.

¹⁴ See Accounting and Auditing Enforcement Release No. 1499.

Second, a presentation of financial results that is addressed to a limited feature of a company's overall financial results (for example, earnings before interest, taxes, depreciation, and amortization), or that sets forth calculations of financial results on a basis other than GAAP, raises particular concerns. Such a statement misleads investors when the company does not clearly disclose the basis of its presentation. Investors cannot understand, much less compare, this “pro forma” financial information without an indication of the principles that underlie its presentation. To inform investors fully, companies need to describe accurately the controlling principles. For example, when a company purports to announce earnings before “unusual or nonrecurring transactions,” it should describe the particular transactions and the kind of transactions that are omitted and apply the methodology described when presenting purportedly comparable information about other periods.

Third, companies must pay attention to the materiality of the information that is omitted from a “pro forma” presentation. Statements about a company's financial results that are literally true nonetheless may be misleading if they omit material information. For example, investors are likely to be deceived if a company uses a “pro forma” presentation to recast a loss as if it were a profit, or to obscure a material result of GAAP financial statements, without clear and comprehensible explanations of the nature and size of the omissions.

Fourth, public companies should consider and follow the recommendations regarding pro forma earnings releases jointly developed by the Financial Executives International and the National Investors Relations Institute before determining whether to issue “pro forma” results, and before deciding how to structure a proposed “pro forma” statement. A presentation of financial results that is addressed to a limited feature of financial results or that sets forth calculations of financial results on a basis other than GAAP generally will not be deemed to be misleading merely due to its deviation from GAAP if the company

in the same public statement discloses in plain English how it has deviated from GAAP and the amounts of each of those deviations.

With appropriate disclosure, accurate interpretations and summaries of GAAP financial statements benefit investors. Our cautionary advice is part of our ongoing commitment to improve the quality, timeliness, and accessibility of publicly available financial information. At the same time, the Commission is focusing on ways in which our current periodic reporting and disclosure system can be updated to fill the void that “pro forma” statements may be attempting to fill.¹⁵

Conclusion

Many of the accounting issues surrounding the accounting for telecommunications capacity contracts are complex, and I have provided only a brief summary of some of the more significant issues. We very much appreciate your prompt action and interest in the current issues that impact financial reporting and our capital markets. You can be assured that the SEC staff takes very seriously allegations of financial reporting improprieties by public companies. Furthermore, in our oversight capacity, the SEC staff will continue to monitor developments in the accounting practices of the telecommunications industry, and provide recommendations for issues that need to be addressed by the accounting standards-setting organizations.

¹⁵ See Testimony of Harvey L. Pitt, Chairman of the U.S. Securities and Exchange Commission, Concerning H.R. 3763, the “Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002,” Before the House Committee on Financial Services (March 20, 2002), explaining the Commission’s disclosure initiatives.